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TAX·FEATURES

Sen. Pete Domenici to Receive 1986 Distinguished Service Award

U.S. Senator Pete V. Domenici, Chairman of the Senate Budget Committee, will receive the Tax Foundation's Distinguished Public Service Award for 1986. Hans W. Wanders, President of the Wachovia Corporation and Chairman of the Foundation's Board of Trustees, announced the decision, and will confer the honor upon the New Mexico Republican at the Foundation's 49th Annual Dinner in New York December 3.

Sen. Pete V. Domenici

"Since 1981, Senator Domenici has handled with grace and skill one of the most difficult leadership positions in the United States Congress as chairman of the Senate Budget Committee," Wanders said in announcing the Board's decision. "Throughout his fourteen-year career in the Senate, Mr. Domenici has been in the front ranks of those urging the nation to turn from unrestrained spending toward responsible use of the resources made available to the Federal government by the taxpayers."

Domenici won election to the U.S. Senate in 1972, after practicing law and heading the municipal government of his hometown, Albuquerque, New Mexico. He was the first Republican elected to the Senate from that state in 39 years. In 1984, he was elected to his third consecutive term, with 72 percent of the popular vote, the largest electoral majority in the state's history.

In addition to chairing the Budget Committee, Domenici serves on the Senate Appropriations, Environment and Public Works, and Energy and Natural Resources Committees. He chairs the energy panel's Research and Development Subcommittee.

In 1983, Domenici served as senior counselor on the President's Bipartisan Commission on Central America, and has played pivotal roles in legislation on such critical issues as equal access to justice, natural gas policy, clean air and clean water legislation, research and development of alternative energy sources, maintenance of wilderness areas, agriculture and waterway user fees.

Domenici graduated from the University of New Mexico and earned his law degree at the University of Denver.

New Federal Tax Bill Boon to Most States But Bane to Others

While uncertainties abound as to the short- and long-term effects of the Federal tax bill as it moves toward final passage, one effect is highly predictable: the majority of states will place income tax revision at the top of their legislative tax agenda in 1987. The issues will focus on whether (or how) to adjust state tax laws to avoid revenue distortions that could result from existing linkages in state laws to the Federal Internal Revenue Code.

Potentially, at least 37 states and the District of Columbia would gain revenues because of the Federal tax reform if they did not drop their conformity to Federal law or take other actions.

The "Tax Reform Act of 1986" reduces Federal personal income taxes by around $122 billion over the next five years, while raising corporate income taxes by a similar amount. In both cases, the changes will come from extensive base-broadening coupled with lower

(Continued on page 2)

Estimated Changes in State Personal Income Tax Receipts in 1988 Resulting from Federal Tax Revision[a]

STATES WITH POTENTIAL INCREASES OF AROUND 10% (14): Arizona, ***Colorado,*** Hawaii, Iowa, Kentucky, ***Louisiana,*** Maine, Minnesota, ***Missouri, Montana, New Mexico, New York, Oklahoma, Utah***

STATES WITH POTENTIAL INCREASES OF 8 OR 9% (7): California, ***Delaware,*** District of Columbia, ***Kansas, Maryland, Virginia,*** West Virginia

STATES WITH POTENTIAL INCREASES OF 6 or 7% (5): Georgia, Indiana, ***Michigan, Ohio,*** Wisconsin

STATES WITH POTENTIAL INCREASES OF 5% or less (11): Alabama, Arkansas, Idaho, ***Illinois,*** Massachusetts, Mississippi, New Jersey, North Carolina, Oregon, Pennsylvania, South Carolina

STATES WITH POTENTIAL DECREASES OF ABOUT 10% (4): ***Nebraska, North Dakota, Rhode Island, Vermont***

OTHER:

Although ***Connecticut*** has no broad-based personal income tax, its revenue from capital gains taxation would more than double.

[a]Estimates assume that states coupled to portions of the Federal tax code as of recent dates will conform to changes in new Federal law. States automatically coupled to provisions of "current" Federal law are shown in italics.

THIS ISSUE:

PAGE 1
TF Award
Tax Bill and the States

PAGE 3
Savings Rate Forecasting

INSERT
Tax Reform

(FEDERAL TAX BILL, from page 1)

statutory rates. While changes in both corporate and personal income taxes will be of concern in most states, this article is limited to a discussion of the potential effects of the Federal changes on state personal income tax revenues.

Forty states and the District of Columbia levy broad-based personal income taxes. In 1985 these taxes yielded more than $64 billion. The states vary widely in the extent to which they rely on these taxes. As a portion of state tax collections, personal income levies range from 6 percent in New Mexico to 66 percent in Oregon.

Nearly all of these 41 jurisdictions have some linkage to the Federal tax law, whether explicit or implicit. (See table on page 3 of *Federal Tax Policy Memo.*) As a starting point for computation of state income taxes, 25 states use Federal Adjusted Gross Income (AGI), six states use Federal taxable income, and four are coupled directly to Federal tax liability. Even the six states with little or no formal linkage to Federal law have some ties in that they will be affected by such items as changes in tax shelters, accounting rules, etc., in Federal law.

The Federal Changes

The accompanying table (see below) lists the changes in Federal tax revenues that will result from the new law, as estimated by the Joint Committee on Taxation. By fiscal year 1988, when most of the provisions will be fully effective, the 18 base-broadening provisions shown at the top of the table below would raise Federal personal income taxes by more than $67 billion, or 16 percent, in the absence of any other changes in the law. The largest sources of increase are the repeal of the 60 percent capital gains exclusion, repeal of the second-earner deduction for married couples, repeal of Individual Retirement Accounts for most taxpayers, repeal of the sales tax deduction, restriction of tax shelters through at-risk rules and limitations on passive losses, limitation on deductions for nonbusiness interest, restrictions on employee business expenses and miscellaneous itemized deductions, and revisions in the alternative minimum tax.

The four major provisions reducing taxes would lower Federal revenues by around $111 billion in 1988, or about 26 percent, absent any other changes. These are rate reductions, increases in personal exemptions, increases in standard deductions, and increases in the earned income credit.

Taken together, these pluses and minuses represent a net loss of $41 billion in Federal revenues for fiscal 1988, or just under 10 percent. Over the five years from 1987-1991, this loss would even out to around 6 percent, according to congressional estimates.

Effect on the States

For 19 states, there will be immediate gains or losses in state personal income tax revenues with passage of the Federal law, unless the states quickly change their laws. These are the states that couple their taxes to certain provisions of "current" Federal law. (The table on page 1 shows a range of estimated changes in state tax revenue as a result of the Federal changes. The states in italics are those linked to current Federal law.) Depending upon a given state's conformity to Federal law, changes would range from losses of around 10 percent in 1988 to gains of around 10 percent in some states.

The four states that levy their taxes as a percentage of Federal tax liability—Nebraska, North Dakota, Rhode Island, and Vermont—would experience losses of around 10 percent in 1988, although this would be reduced to around 6 percent for the five-year period 1987-1991. (The Vermont legislature, however, has already voted to adjust the state tax rate so as to avoid a revenue loss as a result of the Federal changes.)

In the 15 other states linked to current Federal law, there would be increases ranging from less than 5 percent in Illinois, which has only limited ties to Federal AGI, to 10 percent or slightly more in Louisiana, Missouri, Utah, Montana, New Mexico, New York, Oklahoma, and Colorado. The other states linked to current Federal law would experience increases ranging from 6 to 9 percent. These changes would automatically take place absent changes in state laws.

(It should be noted that the possible changes in state revenues assume that the composition of income in each state is equal to the average for all states. Actual amounts of change for states with relatively higher or lower shares of income from such items as capital gains and tax shelters would vary accordingly.)

(Continued on page 4)

Estimated Revenue Effects of Individual Income Tax Provisions of H.R. 3838, Fiscal Year 1988

Provision	Change in Federal revenue (In millions)
Major provisions increasing taxes:	
Repeal second earner deduction	$6,016
Repeal income averaging	1,814
Tax excluded part of unemployment compensation	764
Repeal sales tax deduction	4,876
Increase medical deduction floor	1,223
Limit deductions for meals, travel and entertainment	937
Allow employee business expense generally only as itemized deduction; 2% floor on miscellaneous itemized deductions	4,447
Revise treatment of moving expenses	183
Revise capital cost provisions (including repeal of investment tax credit)	2,994
Repeal 60% capital gains exclusion	20,000[a]
Restrict tax shelters (at risk rules and limitation on passive losses)	4,680
Repeal partial dividend exclusion	573
Revise taxation of regulated investment companies	866
Revise alternative minimum tax	3,904
Tighten certain accounting provisions	1,180
Repeal Individual Retirement Accounts for most taxpayers	4,962
Tighten other pension provisions	3,343
Limit deduction for nonbusiness interest	4,511
Subtotal, increases	67,274
Major provisions reducing taxes:	
Rate reductions	-76,812[a]
Increase personal exemptions	-26,298
Increase standard deduction	-6,183
Increase the earned income credit	-2,040
Subtotal, reductions	-111,333
Other provisions, net	3,011
Net change in individual income tax liability	-41,048

[a]Estimated by Tax Foundation.
Source: Conference Report on H.R. 3838, Tax Reform Act of 1986.

Tax Features

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FEDERAL TAX POLICY MEMO

Editor: Edward A. Sprague, Senior Vice President—Program Planning and Tax Policy

SEPTEMBER/OCTOBER 1986

Tax Reform Fallout

In the months ahead, the country is going to be awash with tax advice. Every publisher will be out with their explanation of the big tax reform bill. Seminars on how to cope with it will run endlessly. The lawyers and accountants, who at one point were a little worried about what the flat tax movement would do to their practices, are licking their chops. The parting refrain of the House/Senate conference as they wrapped up the measure in mid-August: We never promised you simplification!

In the days to come, some people will be trying to define just what it all means for the economy and future business prospects. In this task, they will be handicapped severely by the very size and complexity of the reform bill and inadequate tools to measure its effects—the same problems that afflicted the Administration and Congress throughout the long tax reform campaign. Indeed, despite reams of studies, analyses, op-ed pieces, and other materials spawned by the great debate of the past two years, we really have very little to go on as to the overall consequences of H.R. 3838, particularly the long-term consequences, nor are we likely to learn much right after enactment. Final revenue estimates on a static basis for umpteen new provisions will not shed much light. With passage of time, we may gain more insight if tax policy can remain on a fairly even keel. But that is probably much too optimistic an assumption.

Here are some garden-variety observations about the short and intermediate term.

1. ***Increased Business Tax Burdens.*** The transfer of $120 billion or so in tax burdens from individuals to business will not be painless for the economy, for individuals, or politicians. Corporate sector bashing may have played well as pre-1986 election sounds but could become increasingly discordant thereafter.

Repeal of the investment tax credit with relatively harsh transition rules clearly has had a negative impact on business capital spending already. True, the depreciation provisions of the final bill, retaining the heart of the Accelerated Cost Recovery System (ACRS), are considerably more liberal than those of the House version. But even when coupled with lower corporate rates starting in 1987, this will not nearly offset the loss of the investment credit in terms of maintaining productive investment over the current business cycle anyway.

Over five years, the ITC repeal is estimated to account for more than half of the gross revenue pickup from broadening the base of the corporate income tax. But if capital spending continues to sag below projections, a good part of this will not be realized. Other major changes in the corporate sector, including the blockbuster alternative minimum tax and new accounting and capitalization requirements, likely will have adverse effects on investment, too. And, particularly in the case of the minimum tax, the revenue estimators' basic assumption of all taxpayer behavior remaining the same is very suspect. As a large part of the future base of the minimum tax has not even really been defined yet, it's hard to assess its economic effects. But certainly, there will be many adjustments in business organization and strategy to minimize such a punitive levy.

Currently, the impact of sluggish capital spending has been concentrated in, but by no means confined to, the rustbowl, energy, and cyclical industries. High-tech and others are beginning to feel the pinch, too. In calendar 1987, before the full effect of the reduced tax rates are felt, we are at risk of further slowdown in business activity and erosion of employment. The politics of this situation may be quite different than those from the recent past calling for large increases in corporate effective tax rates.

As an indication of how far things have strayed from the Economic Recovery Tax Act of 1981 (ERTA), we reproduce a table below from the fiscal 1987 budget request showing the effect of major legislation on corporate income tax receipts for the 1985-1989 period and then add the estimated effects of H.R. 3838 through 1989. The business tax cut in 1981, which critics claimed had "destroyed" the corporate income tax, was just about washed out by TEFRA and DEFRA. Reform, obviously, will not only eliminate the small remaining business tax cut from the 1981-1984 legislation but pile on significant net increases, particularly after fiscal 1989 not shown on the table.

Effect of Major Enacted Legislation, 1981-1986 on Corporate Income Tax Receipts Fiscal Years, 1985-1989 ($ bils.)

	1985	1986	1987	1988	1989
Economic Recovery Tax Act of 1981	−32.0	−43.4	−51.6	−54.9	−56.2
Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)	19.2	30.3	39.7	42.8	42.6
Highway Revenue Act of 1982	− 0.2	− 0.2	− 0.2	− 0.2	− 0.2
Deficit Reduction Act of 1984 (DEFRA)	3.3	5.8	8.1	9.7	10.6
Net Effect[1]	−12.1	−10.5	− 7.4	− 5.2	− 4.2
Tax Reform Act of 1986		(2)	+25.2	+23.9	+22.5
Total Net Effect	−12.1	−10.5	+17.8	+18.7	+18.3
Addendum					
Net Effect of Period Legislation on Individual Income Taxes	−114.9	−133.5	−170.1	−219.1	−240.8

[1] Individual acts do not sum exactly to net effect because of interaction effects.
[2] Impact on Fiscal 1986 not shown in Conference Report on H.R. 3838.
Source: Budget of the U.S. Government, FY 1987, and Conference Report on H.R. 3838, The Tax Reform Act of 1986.

Material in **Federal Tax Policy Memo** *may be reproduced freely. Credit to Tax Foundation would be appreciated.*

II. ***Rate Reductions and Individual Sector Changes.*** Clearly, the individual marginal rate reductions were the driving force for reform from the beginning. It is interesting to note that the basic rate structure that finally emerged is virtually identical to the original Bradley-Gephardt proposal back in 1982, which marked the start of the modified flat tax movement as a serious legislative concern. The President put his weight squarely behind rate reduction—some say to the exclusion of legitimate concerns about the business tax burden. And, of course, the dramatic rescue of reform in the Senate Finance Committee last Spring was sparked by the combination of sharply lower top rates and moves against tax shelters that appealed to both conservative and liberal members. Still, the 15 and 28 percent basic rates that the conference eventually approved were accommodated only by accepting the Senate phaseout of the benefit of the 15 percent rate and personal exemption and by a surprising backdown by the House accepting complete repeal of the state/local sales tax deduction.*

It should be kept in mind, of course, that people pay taxes not tax rates. With all the churning of the tax base, the loss or restriction of itemized deductions, the repeal of income averaging and the second-earner deduction, the increase in effective capital gains taxation, and the attack on tax shelters, significant numbers of taxpayers in income groups above $20,000 will experience tax increases. A Joint Committee on Taxation analysis of the Senate bill indicated that 26 percent of the $20,000-$30,000 AGI group would incur such increases and that percentage would rise irregularly to 44 percent of the over-$200,000 AGI group. Very similar proportions should pertain to the final bill which, for purposes of this comparison, is very close to the Senate version. Furthermore, although the conference agreement did ameliorate the "stagger" problem in the Senate bill of tax rates being lowered six months after deductions were lost, it didn't solve it. The March 15, 1987, effective date for rate reductions still means more tax increases for some, or lesser tax decreases for others, in calendar 1987.

Overall, the net tax cut for individuals when the rate reductions are fully effective is said to be 6.1 percent. This probably will have some positive impact on future consumer demand. Ironically, there may be more pronounced effects in the remaining months of 1986 if consumers load up on big-ticket items on which sales taxes are still deductible, cash in capital gains at lower effective rates than next year, and make other timing adjustments to limit the loss or restriction of various tax provisions. But any speedup of consumer buying right now because of these factors could detract from the 1987 economy.

III. ***Federalism.*** Some of the governors have real complaints about the process of Federal tax reform. In general, the Feds appeared to pay little attention to the impact of what they were doing on state/local tax structures and economies. Among the states, there was a lot of discontent about the Administration's proposal to eliminate all state/local deductions from the Federal base. This subsided when the House left the state/local deductions alone but was revived, to a lesser extent, by the Senate Finance Committee proposal to eliminate general sales tax deductibility.

Denying a Federal deduction for one important source of state/local revenue while keeping it for income and property taxes, would seem to clash with our traditional concept of Federalism. It's unlikely to cause states to abandon sales taxes but certainly could affect future choices as to the balance of their fiscal sources. As of 1984, 14 states depended on general sales taxes for 40 percent or more of their overall state tax collections, and 44 states collected 20 percent or more of their total from general sales taxes. Only five had no general sales tax. So it is a significant issue for the governors and state legislatures, who, quite properly, resent the Federal interference.

Their ire may be soothed, however, by the bonanza that most states will get from broadening the Federal income tax base (see *Tax Features* story on page 1 and table on page 3 of this article). The *gross* broadening of the individual and corporate income tax base is estimated to pick up more than $500 billion in Federal revenues over five years and expand the Federal tax base by a multiple of that figure. Almost all of the 41 states with personal income taxes and 46 states with corporate income taxes will get part of this pie. Some would get more than others, depending on the extent to which their own tax bases and personal exemptions are tied to Federal levels. All of the states with income taxes based directly, or indirectly, on the Federal structure will be under pressure to reduce their own rates to pass on the savings to their own taxpayers. But this will not be a uniform process; some will want to use the opportunity to expand state/local expenditure programs.

Also, it should be noted that the "bonanza" is not really automatic. Even among states that copy the Federal base the closest, most do so as of a specific date for the Federal Code. Assuming these want to go along with the Federal changes, they will have to update their relationship and, presumably at the same time, reduce their own rates and/or take other actions.

IV. ***Revenue Neutrality and the Budget Deficit.*** It's hard to believe that H.R. 3838 really will be revenue neutral over five years. Significant change in taxpayer behavior in response to the massive measure can be expected, and generally this will act to undercut static revenue estimates. The revenue estimators, for example, are counting on a very large increase in capital gains tax receipts in 1987-1991. But with the jump in effective capital gains rates, particularly *under* the maximum, realizations could be well below trend, just as they were above trend following the capital gains tax reductions in 1978.

For the short term through fiscal 1987, the reform bill probably still will produce some net revenue gain because of the remaining "stagger," and this offers a partial escape from

*In the "old" days, such a conference provision almost certainly would have been challenged as going beyond the limits of the House and Senate bills. In the case of H.R. 3838, the House version left the sales tax deduction intact while the Senate version preserved 60 percent of it. In these days, however, conference compromises seem to go wherever the conference wants to reach agreement, not the lines drawn by the full House and Senate.

the budget dilemma, a way to help close the budget deficit—on paper anyway—without going through the rigors of a Gramm-Rudman-Hollings sequester. Whether or not the Congressional leadership will accept this "help" for budget reconciliation purposes is uncertain.

No such luck in fiscal 1988, when the budget deficit target is reduced to a little over $100 billion and the reform bill is estimated to lose revenue. Chairman Rostenkowski recently repeated his view that, with a fairer tax base from reform, the budget deficit should be addressed by raising tax rates. We would still bet against this, at least through fiscal 1988 and probably beyond. There is just too much political capital tied up in the lower rates to envision an intermediate-term rate increase. Tax action to help close the deficit, if any, will have to come from another source or sources.

Tax Burden Distribution and Fairness

One thing that Congress never specifically voted on, but which became an important rule of the road for tax reform, was maintaining the existing distribution of individual tax burdens. It probably was necessary to move reform through the political process and avoid class warfare. It was felt that individual tax burdens as between *broad* income classes should remain the same, except for the very bottom, where those below the poverty level would be removed from the rolls entirely. The emphasis would be on more "horizontal" equity *within* income classes, particularly at the upper end.

But unfortunately, there was a downside to this, too. Measurement of tax burdens by income class is somewhat more precise than estimating overall economic effects of tax change, but not much. For numerous special provisions, the Joint Committee on Taxation, although required to provide a revenue figure, is unable to come up with any distribution by income class. Nevertheless, in the tax reform consideration, there was rapt attention paid to very minor projected changes in tax burdens as if they signified major social impact. The whole question of whether the middle-income class should get an estimated 7 percent tax cut, as in the Senate bill, or 9 percent, as in the original House bill, was way overblown.

Decisions were made on some important provisions more on the basis of how many percentage points—or tenths of percentage point—change would occur in the distribu-

Relation of State Personal Income Tax Laws to Federal Internal Revenue Code[a]

As of September 1986

State and nature of link to Internal Revenue Code	Date of linking	Additional linkages to or deviations from Federal base[b]
States linked to Federal AGI (25):		
Arizona	1/1/86	No 2-earner deduction; Federal itemized deductions but no medical expense floor; Federal tax deductible
Colorado	Current	No 2-earner deduction; Federal itemized deductions; Federal tax deductible
Delaware	Current	Federal itemized deductions; limited Federal tax deduction
Dist. of Columbia	5/24/85	Federal itemized deductions; no 2-earner deduction
Georgia	1/1/81	Limited IRAs, no 2-earner deduction; Federal itemized deductions as of 1/1/81
California	1/1/86	$1,500 limit on IRAs; no 2-earner deduction or dividend exclusion; does not tax unemployment compensation; Federal itemized deductions
Illinois	Current	Taxes 100% of capital gains; no dividends received exclusion; no 2-earner deduction; no itemized deductions
Indiana	1/1/86	No 2-earner deduction; no itemized deductions
Iowa	1/1/86	No 2-earner deduction; Federal itemized deductions; Federal tax deductible
Kansas	Current	Federal itemized deductions as of 12/31/77; Federal tax deductible
Kentucky	12/31/85	Federal itemized deductions; limited Federal tax deduction
Louisiana	Current	Federal itemized deductions; Federal tax deductible
Maine	12/31/85	Federal itemized deductions
Maryland	Current	No 2-earner deduction; no dividends received exclusion; Federal itemized deductions
Massachusetts	1/1/85	Taxes 50% of capital gains; no IRAs; no 2-earner deduction; no itemized deductions
Michigan	Current	No 2-earner deduction; no itemized deductions
Minnesota	12/31/85	Does not tax unemployment compensation; generally allows Federal itemized deductions; Federal tax deductible under optional rate schedule
Missouri	Current	Federal tax deductible; provides optional Federal standard deduction; Federal itemized deductions
Montana	Current	Does not tax unemployment compensation; Federal itemized deductions; Federal tax deductible
New Mexico	Current	Generally allows Federal itemized deductions
New York	Current	Federal itemized deductions
Ohio	Current	No itemized deductions
Virginia	Current	No 2-earner deduction; Federal itemized deductions
West Virginia	1/1/86	No 2-earner deduction; Federal itemized deductions
Wisconsin	12/31/85	No 2-earner deduction; no Federal itemized deductions
States linked to Federal taxable income (6)[c]:		
Hawaii	12/31/85	No 2-earner deduction; Federal itemized deductions but not Federal exemptions and standard deduction
Idaho	1/1/86	Federal exemptions and deductions
Oklahoma	Current	Does not use Federal exemptions and standard deductions; optional Federal tax deduction
Oregon	12/31/84	Federal exemptions and deductions; Federal tax deductible
South Carolina	12/31/85	Federal exemptions and deductions
Utah	Current	Federal exemptions and itemized deductions, standard deduction as of 12/74; current Federal itemized deductions; Federal tax deductible
States linked to Federal tax liability (4):		
Nebraska	Current	
North Dakota	Current	Option to pay tax based on Federal taxable income
Rhode Island	Current	
Vermont	Current	1986 legislature voted to adjust tax rate to avoid loss from Federal tax changes

(Table continued on page 4)

Relation of State Personal Income Tax Laws to Federal Internal Revenue Code[a] (continued)

As of September 1986

State and nature of link to Internal Revenue Code	Date of linking	Additional linkages to or deviations from Federal base[b]
States with little or no linkage to Internal Revenue Code (6)[d]		
Alabama	1-1-82	Allows IRAs; generally conforms to Federal itemized deductions; Federal tax deductible
Arkansas	1-1-83	Allows IRAs
Mississippi		Allows IRAs; Federal itemized deductions
New Jersey		
North Carolina		Allows IRAs; 5% floor on medical expense deduction
Pennsylvania		
States without broad-based income taxes (3)		
Connecticut		Taxes 40% of capital gains, dividends and interest
New Hampshire		Taxes dividends and interest
Tennessee		Taxes dividends and interest
States without an income tax (7)[c]		
Alaska		
Florida		
Nevada		
South Dakota		
Texas		
Washington		
Wyoming		

[a]Covers features relevant to Federal tax changes in 1986.
[b]States shown as allowing "Federal itemized deductions" do not allow deduction of state income tax in computing state tax.
[c]In addition to these six states, North Dakota allows taxpayers to choose between computing tax based on Federal taxable income or a percentage of Federal tax liability.
[d]All of these states tax 100% of capital gains as ordinary income.
Source: Tax Foundation compilation based on Commerce Clearing House, *State Tax Guide*.

tion table than the policy logic itself. Heavy reliance on the distribution tables was particularly evident in the decisions to tax capital gains as ordinary income, and thus justify the lower rates as applied to upper-income groups, and also in the restrictions on passive loss deductions. The effects of these reforms on investment incentives were relegated to the background.

In the end, Congress produced a huge mass of changes that, on paper anyway, showed very little difference in the overall proportions of taxes paid by income groups, except, of course, for the very bottom. In the torturous pursuit of the "correct" distribution, some important policy considerations may have been overlooked or ignored.

Despite the jerry-built reform process and disturbing tendency of the tax-writers to make a number of their decisions retroactive, the individual income tax structure, on balance, could be viewed as "fairer" in the future if taxpayers believe that others in the same general economic circumstances are paying taxes in the same ballpark. The perception of horizontal equity is very important. If reform succeeds in improving this, it will go a long way to renew some respect for the system and restore compliance.

Efficiency and Growth

Right after announcement of the 1984 Treasury reform proposal, there was a spate of econometric studies, mostly concluding that such reform would cut capital spending and dampen economic growth. These were criticized for not taking into account the long-term productivity improvement that would accrue from lower rates and better measurement of economic income, etc. But neither the Treasury nor anyone else ever produced any convincing, in-depth analysis of prospective efficiency gains. Then much of the proposed improvement in income measurement, such as through indexing and relief of the double taxation of dividends, went a'glimmering in Congress. We are left really with a good faith decision that the lower rates and somewhat more even distribution of tax burdens will produce a more efficient system. Which they may do. There is no denying that if we can maintain a top corporate tax rate of 34 percent and a top individual rate of 28 percent (or even 33 percent temporarily) this will help make the United States an attractive marketplace in the global context. Note the key words, *"if we can maintain . . ."* This may be the biggest uncertainty of all.

****

In the coming months, this column will be looking closely at sectors most affected by tax reform, including capital recovery, employee benefits, and foreign source income. Whatever the macro effects of reform, there are many significant sectoral issues that will need to be analyzed carefully for the inevitable next round of tax legislation. As Majority Leader Bob Dole put it, "There will be a technical corrections bill, and maybe some things that are not so technical will be dealt with at that time."

Federal Red Ink Cuts Savings Rate By Nearly ⅓

Fiscal profligacy by government—notably by Uncle Sam—is reducing the gross savings rate in the United States by nearly one-third, Tax Foundation analysis reveals.

In the second quarter of 1986, gross private savings of individuals and businesses totaled $718.7 billion, or 17.2 percent of GNP. State-local transactions added another $59.9 billion to the savings total (1.4 percent of GNP), bringing total savings—excluding Federal transactions—to $778.6 billion, 18.6 percent of GNP.

Federal red ink cut that savings rate by more than 30 percent, reducing actual gross savings to 13.0 percent of GNP, economists at the Washington-based fiscal watchdog organization say.

Combined deficits of all government units in the United States were running at an annual rate of $177.0 billion, seasonally adjusted, in the second quarter of 1986—the largest combined deficit on record. It topped the first quarter deficit of $131.6 billion—by $45.4 billion.

These findings by Tax Foundation economists are based on data recently released by the Bureau of Economic Analysis, as reflected in the national income and product accounts (NIPA). The data vary in several respects from the way governments keep their books. For example, the NIPA data exclude capital transactions that do not represent current flows of income and production—these are purely financial transactions or transactions in existing physical assets.

Overall, government deficits occurred in fourteen of the last sixteen years, 1970 through 1985. In every year during that time, the Federal government operated at a deficit, by amounts ranging from $5.6 billion in 1973 to over $200 billion today. The highest deficit prior to the 1980's was recorded in 1975 at $69.4 billion.

In sharp contrast to the performance of the Federal sector, state and local units combined experienced surpluses every year since 1969, by amounts ranging from $1.8 billion in calendar year 1970 to $70.0 billion in the first quarter of 1986.

(The Bureau of Economic Analysis includes transactions involving state

(Continued on page 4)

THE FRONT BURNER

By Robert C. Brown, President
Tax Foundation

"Beware of the Sooths!"

The ancient Romans used sheep entrails. The plains Indians cast chicken bones. Washington policymakers scan statistical projections. Which system is more reliable is anybody's guess.

As Alfred L. Malabre, Jr., writing in *The Wall Street Journal* last May 12 put it: "Trying to forecast the economy's ups and downs may not be quite as unscientific an enterprise as fortune-telling. But it assuredly lacks the precision enjoyed by, among others, the TV weather people."

Perhaps the mistake originated in the economists' desire to gain stature by claiming a predictive ability for the specialty that it did not possess. Perhaps the fault belongs to the politicians who cynically practice "rent-a-consultant" in order to produce forecasts that fit their policy options. Maybe it was all of us, frail, frightened humanity, simply translating into twentieth century terms our age-old desire to pierce the veil of the future and carry home the trophy of certainty.

Regardless. Let's repent, and admit that, if anyone could predict the next ten minutes with absolute certainty, he'd be at the racetrack growing rich.

Now all of this would be good clean fun, if the opinings of economists merited only the level of attention accorded the predictions aired on "Entertainment Tonight." The tragedy lies in using such tenuous "scientific" extrapolations to underpin public policy.

Rosy Scenario as applied to the Federal budget is only the most flagrant example of abuse of the economic forecasts. The widely followed and highly regarded Index of Leading Indicators published monthly by the Commerce Department may have a more honorable pedigree than Rosy. But it seems to have little more predictive validity.

For one thing, the Index is still heavily weighted toward domestic manufacturing although we have shifted to an economy that is increasingly dominated by service and export industries. For another, events quite simply do not bear out the Index's predictions. The Leading Index predicted recessions in 1950, 1962 and 1966 that never materialized. Even when the Index correctly predicted a downturn, the peak occurred anywhere from three to 21 months before sliding over the edge into recession. That's not even close enough for government work!

Decision-makers would be just as safe flipping a coin as consulting some of our economic forecasts. In fact, one could picture a day when, by slavishly following "scientific" forecasts that fail to work out, they will be left with no coins to toss.

(FEDERAL TAX BILL, from page 2)

The remaining 22 jurisdictions have the option of updating their laws in response to the new Federal code. Many of them customarily couple to the latest definitions of the Internal Revenue Code and presumably would do so in years to come. The table on page 2 estimates potential increases these states would receive—their taxpayers would pay—if the states do adopt the Federal changes in provisions to which they are now tied.

State elected officials are free to determine their own tax policy, without regard to Federal rules. On the whole, it seems questionable whether many of them will find it politically feasible to pass on to their taxpayers higher state bills simply as a result of changes in Federal law.

Officials in a few states have indicated that they will need to keep the "windfall" increases because of serious budgetary problems. In most states, however, it is expected that adjustments will be made to avoid changes in state revenues.

States have a number of options. Some may choose to increase their exemptions and/or lower statutory rates to leave personal income tax revenues unchanged. Some may choose to keep the income tax "windfall" and lower other taxes, especially general sales taxes which will no longer be deductible in computing Federal taxes.

Still other states may wish to take a wait-and-see stance. The estimated revenue effects of the Federal changes even on national revenues are at best approximations, based on economic and other assumptions that may not prove accurate.

Whatever the various states decide, it is clear that state legislatures will have a crowded agenda in 1987.

(GROSS SAVINGS, from page 3)

unemployment insurance in Federal social insurance funds, in keeping with the concept applied in the unified Federal budget.)

Among states and localities in the second quarter, both general funds and social insurance funds operated in the black. Funds other than social insurance showed a slim surplus of $4.9 billion, the leanest in three years. Social insurance funds showed a combined surplus of $55.0 billion.

Much of the apparent affluence of state-local treasuries is due to the continuing excess of receipts over expenditures in social insurance funds, largely employee retirement systems.

In only two years since 1969 have all governments combined had surpluses—1973 and 1979. During these years, state-local operations—primarily social insurance funds—were sufficient to offset negative balances in the Federal accounts.

Sources of Gross Savings in the United States[a] Calendar Years 1980-1986

Year	Private saving[b]	Government surplus or deficit			Total gross saving
		Federal	State and local	All governments	
	Amount (millions)				
1980	$478,400	$-61,334	$26,800	$-34,534	$443,900
1981	575,500	-63,785	34,116	-29,669	520,800
1982	557,100	-145,868	35,115	-110,753	446,300
1983	592,200	-176,030	47,472	-128,558	463,600
1984	674,800	-169,989	68,475	-101,514	573,300
1985	687,800	-198,038	61,708	-136,330	551,500
1986					
QI[c]	714,800	-201,600	70,000	-131,600	583,200
QII	718,700	-236,900	59,900	-177,000	541,700
	Percent of gross national product				
1980	17.5	-2.2	1.0	-1.3	16.2
1981	18.0	-2.1	1.1	-1.0	17.1
1982	17.6	-4.6	1.1	-3.5	14.1
1983	17.4	-5.2	1.4	-3.8	13.6
1984	17.9	-4.5	1.8	-2.7	15.2
1985	17.2	-5.0	1.5	-3.4	13.8
1986					
QI[c]	17.2	-4.9	1.7	-3.2	14.1
QII	17.2	-5.7	1.4	-4.2	13.0

[a]Data as shown in the national income accounts; government figures vary from those shown in the federal budget and state-local budgets because of conceptual and timing differences. For example, government data exclude amounts associated with purely financial transactions and asset sales.
[b]Includes personal and business saving.
[c]Seasonally adjusted annual rates.
Source: Department of Commerce, Bureau of Economic Analysis, and Tax Foundation computations.

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